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INFO RUEHLD/AMEMBASSY LONDON 0476  
RUFHFR/AMEMBASSY PARIS 1865  
RUEHRO/AMEMBASSY ROME 7721  
RUEHBS/AMEMBASSY BRUSSELS 9791  
RUEHROC/AMCONSUL MILAN 0387  
RUEHMO/AMEMBASSY MOSCOW 1589  
RUFHNA/USMISSION USNATO 7095  
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BT  
EZ1:  
C O N F I D E N T I A L BONN 02879 COMBINED SECTION

EZ2:  
ALSO FOR USOECD AND USEC  
E.O. 12065: XDS 2/8/02 (WOESSNER, WILLIAM M.) OR-M  
TAGS: ENRG, EEWT, GE, SU  
SUBJECT: U.S. SANCTIONS: EFFECT ON SOVIET  
PIPELINE AND AEG.

1. C - ENTIRE TEXT.
2. SUMMARY: ON FEBRUARY 5, AEG BOARD MEMBER WRANGEL AND AEG-KANIS DIVISION HEAD KERLEN PROVIDED ECON MIN AND ENERGY OFFICER WITH A RUN DOWN, ON A CONFIDENTIAL BASIS, OF THE EFFECTS OF U.S. SANCTIONS ON THE CONSTRUCTION OF THE SOVIET GAS PIPELINE ON AEG. THE FIRM BELIEVES SANCTIONS WILL NOT PREVENT THE DELIVERY OF INITIAL GAS VOLUMES TO EUROPE IN ACCORDANCE WITH THE SOVIET'S CONTRACT. AEG WILL BE HARD HIT BY THE SANCTIONS. THE FIRM MAY HAVE TO LAY OFF 2,000 WORKERS AND CLOSE TWO PLANTS - PLANTS WHICH HAVE JUST BEEN MODERNIZED IN AN ATTEMPT TO COMPETE FOR GAS TURBINE BUSINESS ON A WORLD-WIDE BASIS. THE FIRM WILL BE SUBJECT TO NON-DELIVERY PENALTIES FROM THE SOVIETS, AND, AT THE SAME TIME, GE MAY SEEK PAYMENT FOR THE 47 ROTOR SETS IT HAS AGREED TO SUPPLY. BECAUSE THE TERMS OF THE GE-AEG CONTRACT REQUIRE AEG TO TAKE

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State Dept. review completed

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DELIVERY IN THE U.S. A TO ASSUME RESPONSIBILITY FOR EXPORTING THE ROTORS, GE CAN AND MAY CONTEND THAT ITS OBLIGATIONS END WHEN THE COMPONENTS ARE AVAILABLE FOR ONWARD SHIPMENT ON ITS LOADING DOCK. END SUMMARY.

### 3. THE AEG RELATIONSHIP WITH GE:

UNTIL RECENTLY, GE WAS THE LARGEST SINGLE SHAREHOLDER IN AEG WITH ABOUT 10 PERCENT OF OUTSTANDING AEG STOCK. THE KANIS DIVISION HAS BEEN MANUFACTURING TURBINES UNDER GE LICENSE FOR MORE THAN 10 YEARS, FOR EXPORT THROUGHOUT THE WORLD. THERE IS A GENERAL AGREEMENT BETWEEN THE TWO FIRMS, MOST RECENTLY RENEWED IN 1981, PERMITTING THE MANUFACTURE OF FRAME 5 TWO-STAGE GAS TURBINES. UNDER THIS GENERAL AGREEMENT, THE FIRMS NEGOTIATE SUPPLY AGREEMENTS COVERING GE ROTORS, NOZZLES, AND VANES AS AEG BIDS FOR EACH SPECIFIC CONTRACT. AEG WAS IN CONSTANT CONTACT WITH GE AS IT PREPARED ITS BID FOR THE 47 FRAME 5'S IT IS TO SUPPLY FOR THE SOVIET-WEST EUROPE PIPELINE. BEFORE SIGNING ITS CONTRACT (A THREE-WAY AGREEMENT AMONG AEG, MANNESMAN-CROUSET LOIRE, AS GENERAL CONTRACTOR, AND MACHINIMPORT, THE SOVIET PARTICIPANT) IN NOVEMBER, 1981, AEG VERIFIED THE AVAILABILITY OF GE COMPONENTS, INCLUDING THE FACT THAT THERE WERE NO IMPEDIMENTS TO THE EXPORT OR RE-EXPORT TO THE USSR OF THE U.S. MANUFACTURED COMPONENTS.

4. THE AEG-GE CONTRACT DOES NOT CONTAIN ANY PENALTY CLAUSES. ACCORDING TO OUR AEG BRIEFERS SUCH CLAUSES WERE NOT THOUGHT NECESSARY BECAUSE OF GE'S CLOSE COOPERATION IN THE DEVELOPMENT OF THE AEG BID AND BECAUSE OF THE LONG AND COOPERATIVE RELATIONSHIP BETWEEN THE FIRMS. THE AEG-GE CONTRACT CALLS FOR GE TO SUPPLY THE ROTOR SETS TO AEG WHICH WILL BE RESPONSIBLE FOR EXPORTING THEM FROM THE U.S. THUS, IF GE CHOSE TO, IT COULD CLAIM CONTRACT FULFILLMENT IF THE ROTOR SETS WERE AVAILABLE FOR TRANSFER TO AEG ON ITS LOADING DOCK IN SCHENECTADY, N.Y. STRICT COMPLIANCE IS NOT DEPENDENT ON AEG'S ABILITY LEGALLY TO EXPORT THE ROTOR SETS. (WE WERE GIVEN NO INDICATION AS TO HOW GE INTENDS TO TREAT THIS CONTRACT PROVISION, BUT AEG IS CLEARLY WORRIED THAT IT MIGHT HAVE TO PAY FOR COMPONENTS WHICH IT COULD NOT EXPORT INTO THE SOVIET UNION.)

### 5. AEG-SOVIET CONTRACT:

THE THREE-WAY CONTRACT REFERRED TO ABOVE CONTAINS VERY STRICT PENALTY CLAUSES. ALL 47 TURBINES ARE TO BE AT THE DOCK FOR ONWARD SHIPMENT BY SEPTEMBER, 1983. IN ADDITION, THERE ARE SPECIFIC DEADLINES FOR EACH SINGLE TURBINE. THE FIRST GROUP OF "ABOUT 12" TURBINES IS DUE FOR EXPORT IN AUGUST 1982. FALLING BEHIND ON EVEN ONE DELIVERY COULD TRIGGER SUBSTANTIAL PENALTIES.

### 6. EUROPEAN FRAME 5 STOCK:

AEG HAS 4 ROTOR SETS IN STOCK (THESE WERE EXPORTED BEFORE DECEMBER 29). AEG OFFICIALS ESTIMATE THAT THE TOTAL OF ROTOR SETS IN THE HANDS OF GE'S SEVERAL EUROPEAN MANUFACTURING ASSOCIATES IS ABOUT 25. THEY BELIEVE JOHN BROWN HAS 6, ALTHSON, SEVERAL, AND NUOVO PIGNONE THE REMAINDER. FOR THE PRESENT, AEG IS CONTINUING TO MANUFACTURE THE FRAME 5 TURBINES USING THE 4 ROTOR SETS IN ITS STOCK.

### 7. AEG INTENTIONS:

FRG LAW REQUIRES COMPLIANCE ONLY WITH COCOM RULES. U.S. LAWS ARE NOT ACCEPTED AS HAVING EXTRA-TERRITORIAL APPLI-

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CABILITY. NONETHELESS, AEG APPEARS TO HAVE NO INTENTION OF ATTEMPTING TO EVADE THE CURRENT U.S. RESTRICTIONS. WHILE IF THIS WAS THE FIRM'S INTENTION, THEY WOULD HARDLY ADMIT IT TO THE U.S. GOVERNMENT. WE BELIEVE SEVERAL FACTORS MAKE IT UNLIKELY THAT AEG WILL SEEK TO EXPORT THE FOUR ROTOR SETS NOW IN THEIR POSSESSION.

1) AEG, NOT GE, WAS THE EXPORTER OF THE ROTOR SETS IN QUESTION. THIS MAKES THE FIRM DIRECTLY LIABLE FOR THEIR ONWARD SHIPMENT;

2) AEG DOES CONSIDERABLE BUSINESS IN THE U.S., AND WOULD NOT RISK ITS OPERATIONS FOR THE SALE OF 4 TURBINES. (SELLING 4 TURBINES WOULD NOT HELP VIS-A-VIS THE SOVIETS. THE PENALTY CLAUSES DESCRIBED ABOVE WOULD STILL OPERATE TO THE FIRM'S DETRIMENT); AND

3) A LARGE PORTION OF AEG'S BUSINESS IS WITH THE GERMAN GOVERNMENT AND THE FIRM IS UNLIKELY TO JEOPARDIZE ITS POSITION ON DEFENSE CONTRACTS BY VIOLATING GOVERNMENT WISHES.

#### 8. AEG'S FINANCIAL SITUATION:

AS A COMPANY, AEG-TELEFUNKEN IS NOT IN GOOD HEALTH. UNDER THE PREVIOUS BOARD CHAIRMAN, IT HAD BEEN DECIDED TO CLOSE THE KANIS DIVISION'S TWO GAS TURBINE FACTORIES IN ESSEN BECAUSE THERE DID NOT SEEM TO BE SUFFICIENT DEMAND TO JUSTIFY THE MODERNIZATION REQUIRED TO REMAIN COMPETITIVE. THE CURRENT BOARD CHAIRMAN, DR. DURR, REVERSED HIS PREDECESSOR'S DECISION, AND THE FIRM HAS INVESTED OVER DM 100 MILLION IN THE KANIS PLANTS. DURR SOUGHT TO EXPAND KANIS' MARKETING EFFORTS AND TO MAKE THE DIVISION COMPETITIVE ON A WORLD-WIDE BASIS. THE FIRM COMPETED FOR THE CONTRACT FOR THE SOVIET GAS PIPELINE BOTH IN ANTICIPATION OF FUTURE SOVIET BUSINESS (FOR THE SECOND STRAND OF THE WEST EUROPEAN LINE AND FOR OTHER SOVIET PROJECTS) AND TO PROVIDE WORK UNTIL SUCH TIME AS THE REVITALIZED MARKETING EFFORT PRODUCED ADDITIONAL CONTRACTS IN NEW MARKETS. KANIS EMPLOYS ABOUT 2,000 WORKERS IN THE ESSEN AREA, AND AEG HAS TOLD US THAT NO ALTERNATIVE EMPLOYMENT EXISTS WITHIN THE FIRM, IF THE DIVISION FOLDS. IN ADDITION, AEG ESTIMATES THAT MORE THAN A THOUSAND OTHER JOBS, IN FIRMS WHICH ARE SUB-CONTRACTORS TO KANIS, WOULD BE LOST IF THE PLANTS ARE SHUT DOWN. UNEMPLOYMENT IN THE ESSEN AREA EXCEEDS THE NATIONAL AVERAGE OF 8.2 PERCENT AND IS ESTIMATED BY THE LAND GOVERNMENT TO BE ABOUT 9.1 PERCENT, WITH 23,200 PERSONS REGISTERED AS UNEMPLOYED.

#### 9. CAPABILITIES OF ALTHSEM-ATLANTIQUE (A-A):

AEG HAS TOLD US THAT WHILE A-A HAS MANUFACTURED GAS TURBINES UNDER LICENSE IN OTHER SIZES, THEY HAVE NEVER PRODUCED A FRAME 5, ALTHOUGH THEY HOLD THE NECESSARY LICENSES TO MAKE THE ENTIRE TURBINE, INCLUDING THE ROTOR SET. A-A ACCEPTED AN ORDER FROM THE SOVIETS TO PRODUCE 40 REPLACEMENT ROTOR SETS TO BE USED AS SPARES FOR THE PIPELINE AND IS IN THE PROCESS OF OBTAINING THE NEEDED FACTORY SPACE AND EQUIPMENT. ACCORDING TO AEG, WHICH IS IN CLOSE CONTACT WITH ALL THE OTHER GE LICENSEES IN EUROPE, A-A WILL BE HARD PRESSED TO MEET ITS 1984 DELIVERY DATE FOR THE REPLACEMENT ROTOR SETS. EVEN WITH UNLIMITED INVESTMENT, AEG BELIEVES IT WILL BE IMPOSSIBLE FOR A-A TO PRODUCE ALL OF THE REQUIRED ROTOR SETS WITHIN ANY REASONABLE TIME FRAME. THERE IS NO POSSIBILITY OF DOING SO IN TIME TO AVOID THE PENALTY CLAUSES IN THE AEG-SOVIET CONTRACT.

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10. SOVIET TURBINE PRODUCTION CAPABILITIES:

AEG TELLS US THAT THE SOVIETS MAKE A SERVICEABLE 10 MEGAWATT (MW) TURBINE, AND THAT IT IS POSSIBLE TO BUILD THE PIPELINE FOR LIMITED DELIVERIES OF GAS USING THESE TURBINES. THE SOVIETS ALSO HAVE A PROTOTYPE OF A 25 MW TURBINE SIMILAR TO THE FRAME 5. THIS IS STILL IN THE DEVELOPMENT STAGE, BUT COULD APPARENTLY BE READY TO GO INTO SERVICE BEFORE THE PHASED GAS DELIVERY CONTRACTS REQUIRE THE DELIVERY OF VOLUMES WHICH EXCEED THE SUM OF EXCESS CAPACITY IN THE PRESENT LINES FROM EAST TO WEST AND A NEW LINE RUN WITH 10 MW TURBINES. THE SOVIETS REPORTEDLY ARE ALREADY DISCUSSING THE PRODUCTION OF THEIR 25 MW TURBINE IN EUROPE UNDER LICENSE. SUCH A DEVELOPMENT, IN AEG'S VIEW, WOULD NOT ONLY CUT OUT EUROPEAN PARTICIPATION IN THE PRESENT PIPELINE, BUT WOULD ALSO MAKE THE SOVIETS FAR MORE LIKELY THAN HERETOFORE TO DEVELOP THEIR OWN GAS PRODUCTION EQUIPMENT CAPABILITY. SUCCESSFUL DOMESTIC PRODUCTION WOULD ALSO ALLOW THE SOVIETS TO COMPETE ON A WORLD-WIDE BASIS.

11. SOVIET ATTITUDES TOWARD THE SANCTIONS:

AEG BELIEVES THAT THE SOVIETS HAVE TAKEN A "WAIT AND SEE" ATTITUDE UP TO NOW. THEY HAVE BEEN EXPLORING THE POSSIBILITY OF INCREASING DELIVERIES THROUGH THE EXISTING PIPELINE. (AEG BELIEVES THAT SUFFICIENT SPARE CAPACITY EXISTS TO ENABLE THE SOVIETS TO DELIVER AT LEAST THE FIRST PHASE OF ABOUT ONE-THIRD OF TOTAL CONTRACTED VOLUME ON SCHEDULE WITH NO GREAT DIFFICULTY.) IN EARLY FEBRUARY, THE SOVIETS HELD A MEETING WITH THEIR GENERAL CONTRACTOR, MANNESMAN-CROUSET-LOIRE, TO ENQUIRE ABOUT THE EFFECT OF THE SANCTIONS. KERLEN TOLD US THAT AEG DID NOT ATTEND THE SESSION, BUT WAS BRIEFED ON THE OUTCOME. THE SOVIETS APPEAR TO BE BEGINNING TO PUT PRESSURE ON THE GENERAL CONTRACTOR, WHICH IN TURN IS EXPECTED TO PRESSURE ITS SUPPLIERS. IN AEG'S CASE, THE SITUATION IS MADE EVEN MORE COMPLICATED BECAUSE THEY ARE RESPONSIBLE FOR THE EXPORT OF GE ROTORS FROM THE U.S. AND HAVE NO ONE TO APPLY PRESSURE TO IN TURN. APPARENTLY, THE SOVIETS HAVE THE FLEXIBILITY TO HOLD OFF DECLARING SUPPLIERS IN DEFAULT AT THEIR OPTION.

12. COMMENT: AEG IS CAUGHT IN THE MIDDLE. THE FIRM NEGOTIATED OPENLY WITH GE BASED ON A LONG AND MUTUALLY BENEFICIAL RELATIONSHIP. IT LANDED AN ORDER WHICH IT BADLY NEEDED BY COMPETING ON PRICE AND ON DELIVERY TIMES (CRITICAL BECAUSE OF THE DIFFICULTIES OF MOVING LARGE EQUIPMENT ACROSS THAWING TUNDRA). IT HAS ALWAYS TAKEN DELIVERIES OF ITS ROTORS FROM GE ON THE LOADING DOCK AND HAS HAD NO PROBLEM WITH EXPORTING THESE COMPONENTS IN THE PAST. ALL CONTRACTS WERE SIGNED BEFORE THE IMPOSITION OF SANCTIONS AND IN FULL COMPLIANCE WITH ALL EXISTING REGULATIONS. THE FIRM FEARS THAT GE MAY SEEK PAYMENT FOR COMPONENTS WHICH IT CANNOT USE AT THE SAME TIME THE SOVIETS TRIGGER THE PENALTY CLAUSES FOR NON-RECEIPT OF THEIR TURBINES. AEG BELIEVES THE EMBARGO WILL NOT PREVENT THE SOVIETS FROM DELIVERING GAS TO THEIR EUROPEAN CUSTOMERS ON TIME. IN ADDITION, THE SOVIETS MAY POSSIBLY DEVELOP TURBINE TECHNOLOGY THEMSELVES THEREBY REDUCING THEIR FUTURE DEMAND FOR WESTERN GAS TURBINES. FINALLY, AEG BELIEVES ITS BUSINESS WILL SUFFER IN OTHER GEOGRAPHIC AREAS WHICH ARE VITAL TO THE FIRM'S SURVIVAL BECAUSE, AS A GE MANUFACTURING ASSOCIATE, THE FIRM REMAINS DEPENDENT

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ON U.S. PRODUCED PARTS. THE FIRM HAS NO ANSWER TO CUSTOMERS, E.G. OPEC COUNTRIES, WHO ASK IF THE U.S. IS LIKELY TO BAN SHIPMENTS OF ROTOR SETS IN THE FUTURE, WITH OR WITHOUT A SIGNED CONTRACT BETWEEN AEG AND GE. END COMMENT.  
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